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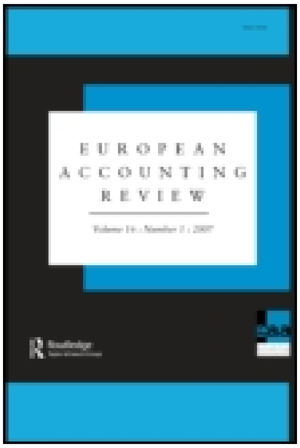

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Doctoral reports

Preparation and information content of consolidated financial statements

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For many years consolidated financial statements have been recognized as the best means to disclose the financial position and performance of a group of companies as a whole. However, some authors have questioned the usefulness of consolidated financial statements. It has been stated that agreement is lacking as to the proper approach to preparing consolidated accounts and that the preparation generally followed is not grounded in accounting theory. Contemporary rules are considered to be the outcome of confused ideas about the function of consolidated statements and it follows that in some respects the outcome of using those rules will be a confused representation.

This thesis tries to contribute to a better understanding of the function of consolidated financial statements in order to be able to make well founded decisions with respect to the consolidation options. The following questions are considered:

1 Which functions can be distinguished with respect to consolidated financial statements?
2 Which unique valuation and allocation problems are involved within the process of preparing consolidated financial statements and which are the options available?
3 In which way can the options can be linked with the functions?
4 What impact do the options have on the financial position and results reported and how do they affect the function of the consolidated financial statements?
5 Which incentives have led managers of Dutch companies to consolidate their financial statements on a voluntary basis?

The function of the consolidated financial statements can be analysed in several ways. To discuss their function in depicting profitability, solvency and liquidity, we follow Walker who has drawn up seven propositions. An analysis of these propositions leads to the conclusion that consolidated

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financial statements are not always superior to separate financial statements. This is certainly true when subsidiaries are partly owned and there are no cross-guarantees of debts between the members of the group. The consolidated balance sheet may also provide a biased impression of the security provided to creditors of the individual companies within the group. Concerning extraordinary items, consolidated financial statements may give a better picture of the composition of the parent-company income than the separate parent-company statements. In that case, consolidated financial statements may provide a better guide to predicting the future income of the parent company.

The information theory developed by Theil and Lev provides quantitative rules for measuring the loss of information due to aggregation. Aggregation implies that data become less detailed. It may be assumed that users of financial statements in principle would prefer to have access to detailed rather than aggregated data. At the same time, however, aggregated data are more surveyable and easier to use. Therefore, one should try to find a balance between the loss of information content on the one hand and 'information overload' on the other. The information theory approach involves the measurement of the loss of the information based on the concept of the entropy. With respect to the consolidation process a consolidation-entropy was developed which could be used to measure the financial statement changes due to consolidation. However, an important limitation of the entropy concept is that the information content is expressed only syntactically and that it is not based on the relevance of the message to the receiver. Consequently, there is no guarantee that the information value will be measured adequately. Therefore, the concept of the entropy can play only a limited role with respect to evaluating the options available in the consolidation process.

Preparing consolidated statements means that decisions have to be made concerning the consolidation criteria and the consolidation method. The function assigned to the consolidated financial statements may have an enormous impact on the number and extent of the options. With respect to the function assigned to consolidated financial statements there are a lot of choices. To keep the analysis manageable and clear, only two, extreme, possible functions of consolidated financial statements are considered:

1 Consolidated financial statements are a part of the notes of the parent company statements and are intended to give additional information to the shareholders of the parent company.
2 Consolidated financial statements are separate financial statements, intended to satisfy the information needs of all the participants of the group.

The result of the analysis shows that, if consolidated financial statements are considered as independent financial statements, system adjustments are required when group companies use different valuation systems. Elimination of intercompany profits according to the theory of divergent majority and minority interest and proportional consolidation is not allowed. Also, the minority interest should be regarded as owners' equity. From the point of view of the group this amount is available on a permanent basis, it is risk sharing and the shareholders have proprietary rights which can be exercised at the annual meeting of the subsidiaries. In the same way, the minority interest in the net income should be treated as a part of the net income of the group.

If consolidated financial statements are considered to be a part of the notes of the financial statements of the parent company, adjustments for differences in the valuation and allocation systems are not strictly required. Also, the proportional method and the theory of divergent majority and minority interest for the treatment of intercompany profits are allowed. If full consolidation has been applied, the minority interest on the consolidated balance sheet can be considered as part of the liabilities. From the viewpoint of the parent-company shareholders, the minority shareholders are outsiders, i.e. a special kind of creditor. In that case the minority interest on the consolidated income statement is part of the expense. They can be compared with the interest expenses on a loan.

The consolidation of financial data and the choices regarding the consolidation criteria and consolidation method will have an impact on the amount and composition of equity and income reported. In most cases, consolidation has an unfavourable impact on the debt ratio. This is because debts of both the parent and subsidiaries are aggregated, whereas shareholders' equity in the subsidiaries will be eliminated. Also the elimination of intercompany profits negatively affects the debt ratio. 'Minority interest' may be seen as a part of shareholders' equity in the group. This positively affects the debt ratio. As minority interest in most cases is a small part of the total capital, the effect will be limited. The impact of consolidation on the current ratio is less predictable. If the relative ratios between current assets and current liabilities of the parent company and the subsidiaries are similar, the consolidated current ratio will as a rule be more favourable than the current ratio of the individual financial statements. This is due to the elimination of intercompany profits and intercompany receivables and payables.

Intercompany profits will as a rule lead to a higher reported return on equity in the consolidated financial statements. This is because the elimination and insertion of intercompany profits will usually have no, or only a limited, impact on the net income and will lead to a decrease of the owners' equity.

To contribute to a better understanding of the function of consolidated financial statements, empirical research has been conducted with respect to the incentives which the management of parent companies may have, to prepare consolidated financial statements on a voluntary basis. For that purpose, out of a large number of financial statements, seventy-one Dutch financial statements were traced, that can be designated as the first consolidation of that company. In the sample a relatively small group of companies (eleven out of seventy-one) started to publish consolidated financial statements during the period from 1925 to the early 1930s. From 1946 (after World War II) there was a gradual increase. At the end of the 1950s and in the first half of the 1960s, a considerable extension in the number of first consolidators can be observed. Influenced by the '*Wet op de Jaarrekening van Ondernemingen*' of 10 September 1970, a considerable increase of 'first' consolidators can be observed in 1969, 1970 and 1971. After 1971 only a relatively small number of companies publish consolidated financial statements for the first time.

With respect to the explanations of the first consolidation provided in the financial statements, it was observed that no explanation had been given by forty (56.3 per cent) companies in the sample. Out of the thirty-one companies that gave reasons for their first consolidation, nineteen (26.8 per cent) companies stated – in various terms – that they intended to increase insight into the financial position and/or activities of the company or group of companies. In four (5.6 per cent) financial statements it was – in various terms – stated that the consolidated financial statements were intended to increase insight into the balance-sheet item 'Interests in subsidiaries'. Eight of the investigated companies mentioned different motives.

To gain further insight into the motives of firm managers for preparing consolidated accounts, five hypotheses were formulated and examined. Two hypotheses concern the changes in the level of activities that are carried out through subsidiaries and one deals with changes in the agreements with the providers of debts. Finally, two hypotheses with respect to opportunist behaviour are considered to be a possible explanation for reporting consolidated financial statements on a voluntary basis.

To test the hypotheses with respect to the level of activities carried out through subsidiaries, the changes in the item 'Investments in subsidiaries' on the balance sheet and the item 'Profit on investments in subsidiaries' on the income statement of the parent company were measured. In our sample we found a significant increase of the amount of the 'Investments in subsidiaries' in the first year of the consolidation compared to the previous year. Also the 'Profit on investments in subsidiaries' on the income statement had increased, but this increase could not be considered as being significant.

The financial data of the voluntary consolidators have also been compared with one of a control group. The control group consists of companies that could have consolidated, but did not. These findings show that the balance-sheet item 'Investments in subsidiaries' in the sample of consolidators is a significantly larger part of total assets than in the group of non-consolidators. This is also true with respect to the 'Profit on investments in subsidiaries' on the income statement.

With the available research data it is not possible to observe the number of cross-guarantees between the group companies. To test the hypothesis with respect to the agreements with the providers of debts it has been assumed that, when the debt ratio and current ratio are less favourable, more cross-guarantees between the group members are required by the providers of debts. In our sample we found no support for accepting this hypothesis. Comparing the voluntary consolidators with a control group shows that voluntary consolidators report a significantly more unfavourable debt ratio than the control group, while the differences with respect to the current ratios are not significant.

The results of the test of the hypothesis with regard to opportunist behaviour indicate that owners' equity and net income in the consolidated financial statements are higher than those reported in the parent-company financial statements. The differences with respect to the owners' equity are significant, while the differences with respect to the current ratios are not. The higher amount of owner's equity reported within the consolidated financial statements may possibly be a reason for the management of the parent company to publish consolidated financial statements on a voluntary basis. However, the return on equity and the debt ratio are less favourable and this may make the management of the parent company more reserved as to publishing consolidated financial statements on a voluntary basis.

NOTE

The original title of the thesis in Dutch was *Consolideren en informeren, een onderzoek naar de informatieve waarde van de geconsolideerde jaarrekening*. The supervisor was Professor Dr J.g. Kuijl, RA. The thesis was examined in June 1995 at the Faculty of Economics and Business Administration of the University of Limburg in the Netherlands.

Quantitative aspects of compensation of losses and their effect on the company annual accounts

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The subject of the dissertation was the quantitative aspects of compensation of losses within the Dutch fiscal system, in particular their effect on company accounts. Emphasis was placed on studying deferred tax assets. This was seen as an important area for study because the knowledge available in tax practice of the quantitive aspects of compensation of losses was so limited. Knowledge of these aspects is important both to fiscal science and to financial accounting, and thus the study could make a contribution to these disciplines.

The fiscal rules for compensation of losses have important consequences for company annual accounts. This is because in drawing up company annual accounts the question arises whether a value can be, or should be, attached to the right to carry forward a tax loss. If sufficient taxable results are not realized within a period, the right to compensate future results with past losses expires and the right loses its value. In the Netherlands the period for carrying forward a tax loss, apart from start-up losses, is limited to eight years.

Before answering the question whether a value can be or should be attached to such rights, the phenomenon of deferred taxation needs to be discussed. In the Netherlands taxable results and commercial results may differ because the concepts of taxable results and commercial results are not entirely equal. In company annual accounts a temporary difference between these two concepts gives rise to a period tax allocation. Two kinds of deferred taxes may be distinguished: deferred tax liabilities, and deferred tax assets. Deferred tax assets are conditional claims originating in the current financial year or in a previous financial year. Apart from deferred tax assets resulting from general temporary differences between taxable and commercial results, it is important to distinguish those deferred tax assets which result specifically from the right to carry forward a tax loss.

It has been suggested that the requirements for accepting deferred tax assets on account of rights to carry forward a tax loss should be stricter than those for accepting deferred tax assets on account of temporary differences between taxable and commercial results. In this study it was demonstrated that such a distinction between these different kinds of deferred tax assets is not relevant. Under the recently published Dutch accounting principles, the acceptance of deferred tax assets on account of rights to carry forward a tax loss no longer has to meet any requirements other than acceptance of deferred tax assets on account of temporary differences between taxable and commercial results. Both have to meet the requirement of there being a 'reasonable expectation' that realization of the tax claim will take place in due course. In this study it was demonstrated that the use of such a reasonability test as a distinguishing criterion is incorrect.

It was shown in the study that it was both more relevant and more correct to make a distinction on the basis of 'certain' or 'uncertain' realization of deferred tax assets. Also that – assuming the continuity of the enterprise deferred tax assets which arise on account of temporary differences, which cannot be offset immediately owing to a lack of taxable results, will not be lost, but will be transformed into deferred tax assets on account of the right to carry forward a tax loss. Consequently, this excludes any uncertainty about the settlement of deferred tax assets on account of temporary differences. In the case of sufficient taxable profits they will be offset immediately; in the case of insufficient taxable profits they will be transformed into deferred tax assets on account of rights to compensation of losses. Therefore, uncertainty about the settlement of deferred tax assets can only exist on account of rights to compensation of losses, and only then if these rights *cannot be* compensated with deferred tax liabilities within the period available for compensation of losses. When these rights *can be* compensated with deferred tax liabilities within the period available for compensation of losses then, in my opinion, realization is objectively ensured. Thus I consider testing on the basis of a subjective criterion, such as 'reasonable expectation', incorrect.

Only in a 'truly uncertain' situation, in which deferred tax assets which have arisen on account of rights to compensation of losses *cannot be* offset against deferred tax liabilities within the period available for compensation of losses, do I consider the aforementioned subjective criterion of 'reasonable expectations' not to be incorrect. The most important factor in deciding when realization in due course may reasonably be expected to take place is empirical data from the past. However, until publication of this study, no such empirical data were available. The aim of the study was to fill this void by carrying out extensive fieldwork regarding the practice of compensation of losses.

The fieldwork was carried out at the Tax Unit/Large Enterprises, Utrecht. The files in this unit are considered representative. More than 4300 observations of taxable profit (both positive and negative) were recorded as fundamental data.

Analysis of the data resulted in the following finding: in only 1 per cent of the cases of taxable entities under study had the aforementioned period during which a tax loss could be carried forward proved to be insufficient to prevent expiry of losses (provided that the continuity of the enterprise was ensured, and provided that their results had: (a) not been tax exempt in advance, or (b) not been determined on an arm's length basis).

Finally, the outcome of the research has had consequences for the treatment of rights to compensation of losses in the company annual accounts in certain situations. Namely, those situations where settlement of deferred tax assets on account of rights to compensation of losses with tax-deferred liabilities has *not* been firmly established in advance. The study demonstrated that realization of rights to tax-deferred assets is the rule (whenever the continuity of the company is ensured, but uncertainty remains on a possible settlement) and expiry of claims to carry forward a tax loss is merely the exception. This conclusion led to the proposal of aiming at a further specification of the existing jurisprudence of the Dutch

Supreme Court concerning this issue. The results of the research have also shown that the formulation used in the recently published Dutch Financial Accounting Standards which reads 'a deferred tax asset should be evaluated if realization of the tax claim may reasonably be assumed to take place in due course' is empirically well founded.

It is legally required that company accounts show a true and fair view of the financial position and results of a company. The fundamental question addressed in this study is, given this requirement, to what extent is it both theoretically correct and empirically well founded that rights to carry forward a tax loss should, in principle, be recognized in full in the annual accounts, although under conditions stipulated in the study? Based on the foregoing, the answer to this question is as follows: with respect to rights to carry forward a tax loss which will be realized with certainty it is theoretically correct, and with respect to rights to carry forward a tax loss which will not be realized with certainty it is empirically well founded, to recognize these rights in full in the annual accounts. However, this is under the condition that the continuity of the company is ensured, and that the results are not tax-exempt in advance and are determined on an arm's length basis.

A dynamic theory of the use of management control systems in achieving alignment between strategic capital investment decisions and strategy

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INTRODUCTION

The primary purpose of management control is to ensure that the behaviour and decisions of people are consistent with the organization's goals and strategies. This research explores how management control systems (MCSs) are designed and used in an organization to help align strategic investment decisions (SIDs) with the firm's strategy. It contributes to the stream of